



International Finance

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German Inflation Headed Upward

The German cost-of-living index for April was only 5.7% higher than its year-earlier level, but is set to rise sharply over the coming months. Indeed, the growth of consumer prices may reach 7.5% or higher in 1980.

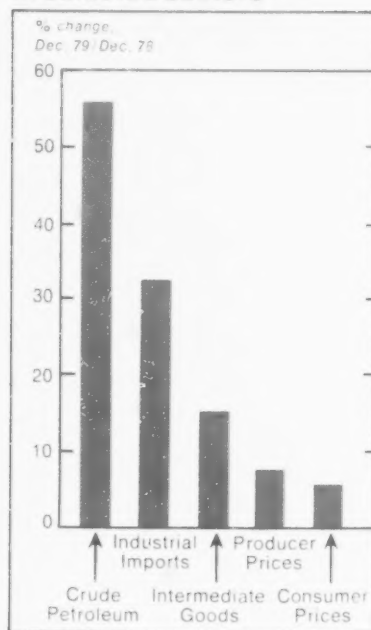
Several forces are converging to boost German inflation rates. First, the impact of the OPEC price shock in 1979, coupled with the general inflation in dollar prices, has not yet worked through the economic system. Second, Bundesbank monetary actions taken in 1979 were not sufficient to stem the upsurge of inflation in 1980. And third, the rapid pace of economic activity in late 1979 and early 1980 has exerted upward pressure on prices and on the velocity of the money supply.

Germany's consumer price index rose less than 6% in 1979, although fuel prices increased by more than 50% and imported goods prices climbed over 25%. The failure of higher prices for imported raw materials and intermediate products to feed through into consumer prices, however, is only a temporary phenomenon. With many input costs increasing at a rate faster than 1% per month, similar increases for consumer prices are not far off. Expectations that the German mark would appreciate against the dollar and reduce fuel and other dollar-based import prices have not been validated. Thus, with no benefits deriving from the foreign-exchange market, the pass-through from import prices to domestic consumer prices will very likely accelerate.

In response to these inflationary pressures, the Bundesbank has moved slowly in boosting short-term rates. The rate adjustment process was begun in March 1979, but at that date rates were unusually low because of the 1977-78 fall of the dollar. Thus, the initial rate increases represented a return to "normal" levels, as opposed to real anti-inflationary moves. Even the interest-rate hike at the end of April (see German highlight on page 2) was viewed as an insufficient monetary policy response. The foreign-exchange markets initially reacted by bidding up the dollar against the mark, even in the face of declining U.S. interest rates.

Finally, the strength of the German economy has helped boost both prices as well as the velocity of the money stock. Velocity was actually declining in 1978 and early 1979 at an annual rate of over 5%. It is now rising at a 4% annual pace. Such a dramatic velocity shift means that any equally dramatic declines in money growth rates have little meaning, and do not constitute an actual tightening of monetary policy.

German price rises
in selected sectors



Canadian GNP growth likely to be flat in 1980.

The Canadian economy appears to be following the United States into a recession. Canada's economy, as the United States', has seen recent declines in housing starts, new manufacturing orders, imports, and retail sales. Other indicators, such as industrial production and unemployment, however, have remained stable. Moreover, Canada has also managed to keep its inflation rate at less than 10% through March, and there is a high probability that it will not come anywhere near the U.S. average of 15% anticipated for 1980. Unemployment has also held steady at 7.4% since the start of the year, but the rate is likely to rise slightly as demand weakens. On balance, the signals suggest a real GNP growth rate for 1980 of either zero or slightly above, as compared with the -0.5% or worse real GNP forecast for the United States.

German central bank rates move higher, but second half may see rate declines.

The German Bundesbank's recent interest-rate tightening took some market observers by surprise. The discount rate was boosted from 7.0% to 7.5% and the Lombard rate, from 8.5% to 9.5%. At the same time, minimum reserve requirements were lowered by 8% and rediscount quotas were raised by 3 billion marks. The net effect was a total injection of approximately 8 billion marks into the banking system. The latest measures are intended to narrow the widening gap that had developed between domestic money market rates, which were over 9%, and the discount and Lombard rates. Another ostensible objective is to counter the recent acceleration in the central bank money stock, whose annualized growth rate over the past three months has risen slightly above the Bundesbank's 5%-8% target range. If the recent rise observed in German bank lending was caused by unintended inventory buildups in the face of weakening consumer demand, the second half of 1980 will likely see a decline in German money market rates, particularly in light of the declining trend in U.S. dollar interest rates. However, rising inflation may temper any very rapid downward rate adjustment.

Italian economic growth continues strong, but policy restraint is likely.

The Italian economy ended 1979 on a strong note. Real GDP in the fourth quarter rose at a seasonally adjusted annual rate of 15.6%, and growth for the year as a whole was revised up to 5%—the fastest economic growth rate of the major European countries. Moreover, the economy apparently continued to grow strong in early 1980, as industrial production in February was some 12% above its year-earlier level. The strong year-end and early 1980 economic growth ensure an average GDP growth rate of at least 3.3% in 1980, well above the earlier official forecast of 1.5%. Inflation and a large and growing trade deficit, however, continue to cause concern, and a tightening of monetary and fiscal policies appears likely. Thus, Italy will not remain immune to the economic growth slowdown that will affect the rest of Europe in the latter part of 1980.

High inflation threatens Swedish growth prospects.

The Swedish Government's 1980/81 budget proposals, first submitted in January, have recently been revised in light of higher-than-expected inflation. The rate of growth of consumer prices has now been boosted to an annualized pace of 13.6%. The higher inflation will increase the budget deficit to some 11% of GNP this year, and the prospect of a widening deficit thereafter has led to plans to slash the growth of future government spending in order to reduce the deficit to 7% of GNP by 1985. Inflation is clearly a major concern of the Swedish authorities. The Government imposed a six-week price freeze effective March 26, stating that the freeze could be extended through 1980 if the unions accept moderate wage settlements. But negotiations are proving exceptionally difficult this year, with unions seeking 11.4% increases and employers offering 4%. Strikes in the public sector have already occurred, and roughly 85% of manufacturing capacity has been halted by strikes and lockouts. If average wage settlements exceed 7.5%—the income growth rate that the Government is assuming in its balance-of-

payments and growth forecasts—Sweden's economic growth prospects will be worsened significantly. A 10% settlement, for example, could raise the Swedish current-account deficit to some 18 billion kronor in 1980—as against the Government's expectation of a 16.6-billion kronor shortfall—and to about 20 billion kronor in 1981.

*Japanese trade
balance will shift
into deficit in 1980.*

Japan's export performance so far this year has recovered from its poor showing in 1979. The value of exports in the first quarter was up 17.2% over the comparable 1979 quarter, with substantial gains in shipments of automobiles, optical equipment, and heavy machinery. The increase in exports, however, cannot simply be attributed to the 17% depreciation of the yen against the dollar over the course of 1979 and the first quarter of 1980, as export prices in dollar terms declined less than 2% in first-quarter 1980. And because of the already narrow export profit margins and the sharp rise in oil and other commodity import prices, it is unlikely that dollar prices of Japanese exports will decline any further in the future. On the demand side, the recession in the United States and possible import restrictions abroad are likely to slow considerably the rate of increase in demand for Japanese exports toward year-end. Therefore, while exports should continue to grow in 1980, their rate of growth is likely to moderate. And with rising imports, Japan's overall trade balance is expected to shift from a surplus of more than \$2 billion in 1979 into a small deficit in 1980.

*New South African
budget limits
state role while
spurring private sector.*

South Africa's \$16-billion budget for fiscal 1980/81 is aimed at stimulating private sector growth, while reducing the public sector's role in the economy. The new budget limits the growth in total state expenditure to 14%, equal to the current inflation rate. Defense, government salaries, housing, and education are the only sectors to receive real increases in allocations. Incentives to the private sector include structural tax reforms, and abolition of the import surcharge and of loan levies. On balance, government revenues are budgeted to increase by 20% to \$13.2 billion, owing largely to an estimated near-tripling of gold mining earnings. It is hoped that the resulting budget deficit of \$2.8 billion—32% higher than in fiscal 1979/80—will spur higher private consumption and investment, and thereby generate more rapid economic growth. Provisions made for financing the deficit without resort to money creation ensure against its adding to South African inflationary pressures.

*India sees
need for greater
export orientation.*

India's traditional neglect of its external sector is showing signs of reversing. Export orientation has taken a long-standing back seat to a policy of import substitution, largely because of the country's vast domestic market and its desire for economic self-reliance. But India's deteriorating balance of payments has apparently triggered some degree of policy reorientation. The trade balance is expected to post a deficit of \$2.7 billion in fiscal 1979/80, double the \$1.3-billion gap of fiscal 1978/79 and nearly 10 times the \$276-million deficit of FY 1977/78. While exports increased 16% on an average annual basis from fiscal 1971 to 1978, they grew only 3.6% in fiscal 1978/79 and only 5% in FY 1979/80. Imports, however, rose 20% in fiscal 1978/79 and 21% in fiscal 1979/80. Indian authorities would like to double India's now-small share of world exports, which would entail annual export growth of 18%. Such a goal may be attained over the next five years, with the appropriate stimuli. In this regard, the authorities have introduced some incentives to spur capital goods exports in the form of increased government financing support. And there is some consideration being given to the establishment of an export credit bank that would finance and actively promote Indian exports.

Money Supply Plummet

The seasonally adjusted money supply in the March/April period registered its sharpest two-month decline in the last three decades. From February to April, M_{1a} declined at a seasonally adjusted annual rate of about 8%; the corresponding drop in M_{1b} was about 5%. In the past, sharp declines in money growth have often occurred either during or just prior to major slowdowns in economic activity. At times, however, forces unrelated to aggregate demand have caused the relationship between money growth and total spending to break down temporarily. While such forces may be partly responsible for the recent dropoff in the money supply, it appears that the slower money growth numbers are more indicative of the combination of a tight monetary policy and a weakening economy.

One hypothesis—unrelated to aggregate demand—as to why the seasonally adjusted money supply has fallen stems from the 1980 revisions of the seasonal factors. These revisions caused seasonally adjusted annual M_{1a} growth in the March/April period to be about 2½% lower than it would otherwise have been. This, however, does not explain most of the decline. In fact, March/April M_{1a} growth adjusted using current seasonals was *stronger* than trend in the previous three years.

The increased speed with which the U.S. Internal

Revenue Service processed income tax payments this April has also been suggested as a "non-demand" reason for some of the slowdown in April money growth. Most of these payments are made by checks drawn against demand deposits—the largest component of M_{1a} —and the longer the processing time, the longer these checking balances are counted in the money supply. Tax payments were processed much more quickly this year than in the previous three years. However, this would only tend to depress the money supply in the latter half of April, and thus would not have contributed to the earlier weakness in money growth.

Still others speculate that the high interest rates in March and April led moneyholders to switch some of their money balances into highly-liquid interest-bearing alternatives. However, net assets in the most widely mentioned of these alternatives, money-market mutual fund shares, increased in March and April by only \$232 million and \$154 million, respectively—the smallest monthly increases in more than two years.

In the final analysis, it appears that the recent drop in money growth supports the view that the current economic slowdown is proving to be sharper than previously thought. It also suggests that the Federal Reserve's credit-tightening actions have been highly effective.

Africa and Middle East Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP in 1978		BALANCE OF PAYMENTS			
		3 months ending	Change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million \$	12-month change	months of imports covered
Algeria	Future LNG expansion program being reassessed.	Dec.	+ 49%	19.3*	\$ 1,075	Mar.	3,044	+ 63%	4.9
Egypt	Increases announced in prices paid by the Government for some farm products.	Dec.	+121%	18.6*	484	Dec.	529	+ 64%	1.8
Ivory Coast	Agriculture's share of expenditures in amended investment budget boosted to 30%.	Sept.	+ 48%	7.6	1,440	Jan.	52	- 88%	0.3
Kenya	GDP growth rate in 1980 unlikely to rise from last year's 3.5%.	Oct.	+ 26%	5.5	370	Mar.	573	+ 56%	4.1
Libya	Domestic production of ammonia and phosphate fertilizers being studied.	Dec.	+ 93%	1.8*	6,635	Mar.	7,960	+116%	13.3
Madagascar	Production of most export and domestic crops continues to decline.	June	+ 24%	2.0	240	Aug.	63	- 30%	1.8
Mauritius	Reductions in food subsidies fuel accelerating inflation.	Mar. '79	+ 18%	0.2	872	Mar.	43	+ 51%	1.4
Morocco	World Bank loan of \$112 million granted for oil exploration and highway project.	Sept.	+ 22%	12.8	678	Feb.	407	- 30%	1.3
Nigeria	New budget favors housing, agriculture, and education; defense allocations cut.	Feb.	+ 56%	41.4	520	Mar.	6,520	+204%	6.5
South Africa	Budgetary tax concessions should boost sales of semi-durables and durables.	Dec.	+ 48%	57.3**	2,070	Mar.	649	- 12%	0.9
Tanzania	Import shortages interfere with industrial production; transport problems curb agricultural output.	Apr. '79	+ 15%	4.3	263	Nov.	78	- 29%	0.8
Tunisia	Joint venture set up with Kuwait to produce phosphate fertilizers in Tunisia.	Dec.	- 40%	5.9	966	Mar.	540	+ 41%	2.8
Uganda	Budget gap of \$100 million likely in 1979/80, despite tax and customs duty increases.	Dec.	+ 19%	8.4	650	Aug.	135	+ 40%	3.4
Zambia	Copper production in 1980 to increase 5%-10% over 1979 level.	Dec.	+ 62%	3.2**	573	Feb.	78	+ 53%	1.0
Iran	Budgeted expenditure for current fiscal year down about 10% from year earlier.	Dec.	+ 54%	76.4*	2,227	Dec.	15,208	+ 30%	23.5
Kuwait	Issuance of new work permits fell 43% in 1979.	Mar.	+ 11%	13.9***	12,278	Mar.	2,660†	+ 11%	7.0
Saudi Arabia	Several agreements signed for petrochemical projects.	Dec.	+ 68%	54.5***	8,400	Mar.	18,112†	- 7%	8.5
United Arab Emirates	Budgeted federal outlays set at \$4.3 billion for 1980, up 64% from last year.	Dec.	+ 84%	13.8	19,435	Mar.	10,086†	+ 30%	2.4

*1977

**1979

***FY 1977/78

†Excluding state reserves

Wages Set to Rise Sharply

The unemployment rate's climb to 7.0% in April from 6.2% a month earlier was the first time in more than two years that the rate moved outside of the 6% range. But despite what appears to be a weakening demand for labor, wage gains are not expected to moderate. In fact, they may well accelerate, reflecting persisting inflationary pressure in the economy.

Although the softness in the labor markets has been concentrated in only a few sectors to date, its impact is great. Construction employment dropped 350,000 in the last three months as high interest rates and reduced mortgage availability have slashed the level of housing starts. And the auto industry has laid off over 200,000 as the combination of tight consumer credit, declining real after-tax income, and inability to produce the small, fuel-efficient cars that the public wants has cut domestic sales dramatically. Such employment declines, which are expected to continue, are especially damaging to the economy because they hit high-wage industries. Accordingly, the impact on personal income and spending is more than proportional to the unemployment numbers. Furthermore, data on the distribution of unemployment suggest that it is primarily single-earner households that are suffering the income losses. As these households reduce their spending, layoffs will occur in other industries, such as household furnishings, appliances, and apparel.

Despite the spreading layoffs, however, wage gains for the larger unions are likely to move into the dou-

ble-digit range. The average wage increase in 1979 was 8.8%, following three years of gains of about 8% per year. In new contracts without cost-of-living adjustments (COLAs), or escalator clauses, first-year settlements averaged 8% in 1978, just over 9% in 1979, and about 11% in the first three months of 1980. But the sharper gains show up in labor contracts with escalator clauses. In such settlements, first-year adjustments averaged nearly 7% in 1978 and about 6% in 1979 and so far in 1980. The COLA clauses in these contracts, however, spurred by higher inflation, boosted effective 1979 wage gains to more than 10%. And the recent step-up in the rate of price increases will lift such inflation-linked wage gains still higher in 1980.

Contracts incorporating COLA clauses currently cover 63% of the workers in the larger unions. Moreover, revisions of COLA clauses to ensure improved protection against inflation continue to be a major item on labor's bargaining list. Last year, COLA clauses compensated for about 50% of the increase in consumer prices, a percentage that is expected to rise this year in view of the increased scope and effectiveness of COLA clauses.

On balance, despite the deteriorating employment outlook, 1980 is very likely to see average wage gains for employed workers well into the double-digit range. Only a steeper-than-anticipated recession and more immediate and dramatic relief on the inflation front will moderate the high-wage outlook.

PAYMENTS		MONEY AND BANKING							COUNTRIES
MF mil- lions	current influences on payments	12-month changes				central bank rate	exchange rate in U.S. dollars May 7, 1980	current monetary conditions	
		latest data	consumer prices	latest data	domestic credit				
	LNG exports to U.S. halted, owing to dispute over price hikes.	Dec. '78	+ 17%	Sept.	+ 28%	—	.2650	Euroloan of \$100 million for TransMed pipeline signed.	Algeria
	Oil prices lowered from \$40 to \$34 per barrel for second quarter.	Dec.	+ 10%	Dec.	+ 23%	10.00%	1.45	Interest rates raised one percentage point.	Egypt
	Overall payments deficit was \$143 million in 1979, after three years of surplus.	Dec.	+ 18%	Sept.	+ 27%	8.00%	.004830	Declining foreign assets restricts money supply growth.	Ivory Coast
	Sugar Rehabilitation Scheme will produce exportable surplus in 1980.	Nov.	+ 8%	Dec.	+ 14%	—	.1415	Credit restraint continues.	Kenya
	Oil output was 2.1 million bpd in Jan.-Feb., down 1.8% from year earlier.	n.a.	—	—	—	5.00%	3.41	Credit generally available.	Libya
	Targeted import limit for 1980 unlikely to close trade gap.	Jan.	+ 17%	Sept.	+ 48%	n.a.	.0049	Development banks no longer expanding credit.	Madagascar
	December cyclones estimated to have caused some 20% sugar crop loss.	Dec.	+ 39%	Feb.	+ 27%	10.50%	.1350	Selective credit relaxation for sugar sector.	Mauritius
	Phosphate rock export prices rising.	Mar. '79	+ 10%	Jan.	+ 12%	4.50%	.2650	Money supply growing more slowly.	Morocco
	Raw material and spare parts imports exempt from preshipment inspection.	July	+ 10%	July	+ 14%	5.00%	1.84	Government seeking \$35-million, eight-year Euroloan.	Nigeria
	Non-gold mineral exports of \$4.3 billion expected in 1980, up about 28%.	Feb.	+ 14%	Dec.	+ 16%	7.00%	1.2680	Forward dollar discount raised from 2.5% to 12%.	South Africa
	Small foreign exchange allocations to industry trigger use of supplier credits.	June	+ 12%	n.a.	—	—	.1250	Agricultural credit being emphasized.	Tanzania
	Oil export revenue increasing.	Jan.	+ 11%	Jan.	+ 10%	5.75%	2.72	Credit to private sector growing slowly.	Tunisia
	Aid inflow likely to ensure 80% import increase.	n.a.	—	June	+ 35%	—	n.a.	New currency may restore control over money supply.	Uganda
	Zimbabwe settlement should reduce military spending and import costs.	Dec.	+ 16%	Dec.	+ 8%	—	1.3225	Commercial finance more available.	Zambia
	Oil exports reported down to about 1.3-1.5 million barrels per day.	Nov.	+ 9%	June	+ 33%	9.00%	n.a.	Credit generally available.	Iran
	Oil output averaged 1.95 million bpd in Jan.-Feb., down 16% from year earlier.	Oct.	+ 7%	Jan.	+ 40% ‡	—	3.71	Kuwait Fund lends \$14 million to Niger and Oman.	Kuwait
	Propane prices raised \$25 per ton April 1; butane lowered \$5 per ton.	Dec.	+ 2%	Jan.	+ 87% ‡	—	.3015	Claims on private sector rising steadily.	Saudi Arabia
	Abu Dhabi oil output was 1.4 million bpd in Jan.-Feb., down 5% from year ago.	n.a.	—	Jan.	+ 6% ‡	—	.2700	Currency Board receives \$267 million for real estate loans.	United Arab Emirates

†Private sector only

World Interest Rates

market rates of May 7, 1980; bond yields as of May 2, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan																																																																																																			
Central Bank Discount Rate	13.00	15.40	17.00	14.00	9.50	7.50	15.00 penalty rate 18.00	9.50	3.00	9.00																																																																																																			
Day-to-Day Money	10.50 May 8	18.00	17.25	17.00	12.50	10.50	17.00	11.125	8.00	12.50																																																																																																			
Treasury Bills 91-day, Middle Rates	9.07	13.95	15.8125	16.75	13.52 one-year	n. a.	14.625 84-day	no dealing	no market	6.75 2-month																																																																																																			
Commercial Paper prime, 3-month, asked	9.75 finance paper	14.65 finance paper 15% tax w/h	14.71	13.90 Certified	12.87 Interbank	no market	no market	no market	no market	not traded																																																																																																			
Bankers' Acceptances 3-month, asked	9.50	14.65 15% tax w/h	16.25	15.25 Certified	not traded	9.90	18.40	no market	4.50 not traded	no market																																																																																																			
Government Bonds Long-term, new and old issues, average yield	10.26	11.95	13.67	12.09 20% tax w/h	12.89	9.03	15.00	10.04	4.87	9.40																																																																																																			
Industrial Bonds prime, long-term, new and old issues, average yield	11.05 As Industrials	12.125	14.65	13.90	14.37	9.05	14.83	11.16	5.62	7.75																																																																																																			
Bank Short-Term Rate to Best Borrowers (prime rate)	17.00	16.25	18.00	18.75	14.50	11.50	20.00	12.50	5.50	9.25																																																																																																			
Bank Time Deposits 3-month	9.50 Cert. of Dep.	14.65 Cert. of Dep.	16.5625	16.00	12.9375	10.15	10.75	11.25 large deposits	6.625 residents only	6.00 20% tax w/h																																																																																																			
Eurocurrencies 3-month, asked	11.375	no market	16.875	no market	13.25	9.50	no market	11.25	6.25	no market																																																																																																			
Exchange Rates—in U.S.\$ rates floating against the \$	—	.8450	2.2870	.03490	.2390	.5615	.001189	.5070	.6075	.004335																																																																																																			
Forward Exchange Cover 3-month, in percent p.a. D = discount, P = premium	—	2.70 D	5.75 D	.40 P	1.65 D	1.55 P	4.65 D	.10 P	5.20 P	.95 D																																																																																																			
<table><tr><td>Eurodollar Deposits (London, interbank, bid) May 8</td><td colspan="4">International Arbitrage (3-month, hedged)</td><td colspan="4">Eurobonds (average yield on recent straight debt issues)</td><td colspan="2">Gold Price</td></tr><tr><td>7-day 10.00</td><td colspan="4">+ in favor of U.S. dollars</td><td colspan="4">U.S. Dollar Bonds</td><td colspan="2">London</td></tr><tr><td>1-month 11.0625</td><td colspan="4">U.S.-U.K. Treasury Bills — .78</td><td colspan="4">7 yrs. and under</td><td colspan="2">afternoon fixing</td></tr><tr><td>3-month 11.25</td><td colspan="4">U.S.-Canada Treasury Bills — 1.53</td><td colspan="4">Over 7 yrs.</td><td colspan="2">11.25</td></tr><tr><td>6-month 11.25</td><td colspan="4">U.S.-Canada Finance Co. Paper — 2.00</td><td colspan="4">DM Bonds</td><td colspan="2">11.625</td></tr><tr><td></td><td colspan="4">Eurodollars-U.K. Local Auth. Deposits — .06</td><td colspan="4">7 yrs. and under</td><td colspan="2">9.00</td></tr><tr><td></td><td colspan="4"></td><td colspan="4">Over 7 yrs.</td><td colspan="2">9.00</td></tr><tr><td></td><td colspan="4"></td><td colspan="4"></td><td colspan="2">510.00</td></tr><tr><td></td><td colspan="4"></td><td colspan="4"></td><td colspan="2">(per fine ounce)</td></tr></table>											Eurodollar Deposits (London, interbank, bid) May 8	International Arbitrage (3-month, hedged)				Eurobonds (average yield on recent straight debt issues)				Gold Price		7-day 10.00	+ in favor of U.S. dollars				U.S. Dollar Bonds				London		1-month 11.0625	U.S.-U.K. Treasury Bills — .78				7 yrs. and under				afternoon fixing		3-month 11.25	U.S.-Canada Treasury Bills — 1.53				Over 7 yrs.				11.25		6-month 11.25	U.S.-Canada Finance Co. Paper — 2.00				DM Bonds				11.625			Eurodollars-U.K. Local Auth. Deposits — .06				7 yrs. and under				9.00							Over 7 yrs.				9.00											510.00											(per fine ounce)	
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Hungary Experiments With Creative Reform

The rapid growth experienced by the Hungarian economy in 1977-78 has ended, but the consequences linger. The earlier boom, caused by soaring investment and excellent harvests, has left behind an external debt of over \$6 billion and structural imbalances in the domestic economy. These problems, and the Government's response to them, contributed to slower economic growth in 1979 and are likely to restrain growth for several more years. Real national income grew by only 1.8% in 1979, compared with an average annual rate of 5.3% during 1975-78. While growth is expected to edge up to 2½% in 1980, much of the advance will be concentrated in the export sector, with the expectation of a decline in investment and limited growth in consumption.

A lackluster domestic economy

Most domestic economic indicators pointed downward in 1979. Industrial production growth, for example, slowed to 2.8% from 5.2% in 1978. Largely responsible for the slowdown was a 1½% decline in the industrial labor force triggered by budgetary and credit restrictions on state enterprises. Another influence was the general slowdown in investment growth to a rate of about 3%. Industrial production has been virtually flat since mid-1979, and in the first quarter of 1980 it was only 1% above first-quarter 1979.

Agricultural performance was even less favorable in 1979. A 2% rise in animal-products output was offset by a 2½% decline in crop production, leaving overall production essentially unchanged. The drop was most severe in wheat production, where output fell to 3.7 million metric tons in 1979, down 35% from 1978. A favorable corn harvest boosted total grain output to 12 million metric tons—a level still 11% below 1978. With no increase planned for animal production, total agricultural exports will decline in 1980.

Domestic demand is expected to remain weak. Indeed, total domestic spending on consumption and capital accumulation actually declined last year, with real growth concentrated in net exports. Following annual increases of 4% in 1977 and 1978, it is estimated that real household income fell by 1½-1¾% last year, and the Government's annual plan calls for only limited recovery in 1980.

Adjustments in the external sector

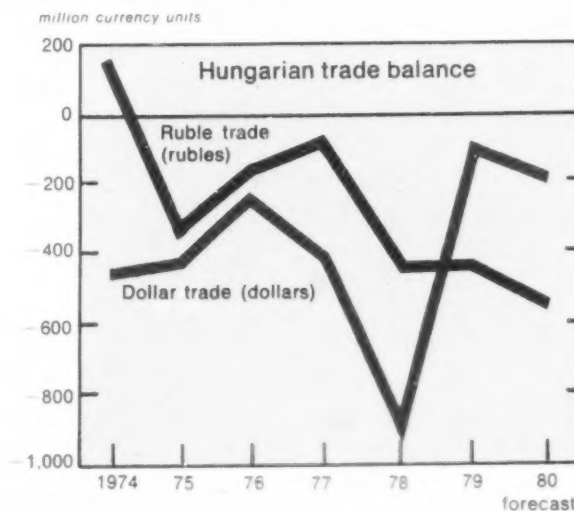
The capital investment boom was largely responsible for the deterioration in Hungary's balance of payments in 1977 and 1978. The trade deficit in convertible currency (including trade with the West, developing countries, and some transactions with Socialist countries) rose from \$418 million in 1977 to \$926 million in 1978. The hard-currency deficit nar-

rowed to \$91 million in 1979, however, as exports increased by more than 30% while imports grew only 6%. Part of the improvement came from a reduction in Hungary's trade deficit with the industrialized countries to \$700 million. Given an approximate balance in trade with developing countries, Hungary apparently achieved a large surplus in its convertible currency trade with Socialist countries (especially the Soviet Union). And in view of Hungary's overall trade deficit with the USSR, the Soviet Union was presumably willing to extend (nonconvertible) ruble credits to finance its exports to Hungary while paying (convertible) dollars for some imports. For 1980, the expectation is that the hard-currency deficit will widen to \$200 million.

Hungary's trade deficit with the USSR in 1979 totaled 327.5 million rubles, after posting a surplus of 33.5 million rubles in 1978. The fastest growing component of Soviet-Hungarian trade is the convertible component, where highly marketable supplemental Soviet crude oil is exchanged for similarly marketable Hungarian beef exports and manufactured products. The Soviet-Hungarian trade agreement for 1980 projects a 500-million-ruble deficit for Hungary, with deliveries of 7.5 million tons of Soviet crude oil and 3.8 billion cubic meters of Soviet gas.

Price policy given pivotal role in reform

Hungarian authorities acknowledged their country's mounting economic problems in 1979 by introducing a comprehensive set of restrictive, but highly innovative, policies. The major problems acknowledged were the inefficiency of industrial enterprises, the irrationality of domestic prices, soaring energy consumption, and a deteriorating balance of payments.



Hungary Experiments With Creative Reform *(continued from page 7)*

To address these difficulties, Hungary's leadership has granted a greater role to price policy than any other Socialist country aside from Yugoslavia. Consumer prices were raised repeatedly during 1978 and 1979, and the cost of living rose about 18% over the course of these two years. The most comprehensive set of price increases was announced in July 1979, when prices of food, energy, and various services were boosted. This was then followed, in April 1980, by an additional increase of 20%-30% in gasoline prices. While modest income supplements were provided for certain low-income groups, they were far from sufficient to cushion the higher cost of living for the broader population.

Prices paid by enterprises were also lifted sharply, as subsidies were reduced or eliminated. Economists defended these actions by arguing that the resulting liquidity squeeze would promote long-run enterprise efficiency by curbing expansions by high-cost producers, controlling discretionary investment, and reducing energy and raw material consumption.

The price reform policy was consolidated in January 1980. Hungarian producer prices were raised to world levels, but more significantly, a mechanism was established for future price adjustment. Domestic prices for raw materials will henceforth be determined by Western market prices, although prices for fuels and electric power will continue to be fixed by central authority. World market prices are to be the standard for domestic industrial prices covering 75% of current production. The major objective of the new price policy is to promote economic efficiency of state enterprises in the 1980s, encourage the adoption of efficient technologies, and guide investment to the most profitable activities. This price-adjustment mechanism was selected rather than allowing import competition to influence the domestic market directly. The latter alternative was ruled out because of the disruption it would threaten for many enterprises with monopoly positions. Moreover, the trade unions and Party officials opposed it because of the unemployment consequences associated with foreign competition.

The authorities have also made significant adjustments in foreign-exchange policy, guided by the long-term goal of a unified, convertible currency. At the beginning of 1979, the forint's exchange rates were modified and exchange regulations for visitors were tightened. The tourist exchange rate was raised from 50% to 75% of the commercial rate to encourage extended visits by Western tourists, while tighter re-

strictions were imposed on visitors' currency transactions.

External financing critical to development

External financing has played a critical role in Hungarian economic development in the 1970s. The country has been a regular user of the Euromarket, relying only minimally on official and supplier credits. After raising nearly \$1 billion in Euromarket syndicated loans in 1979, the National Bank of Hungary has just signed another \$250 million loan from Western banks. This latest loan, the first in 1980, is significant in several respects. First, it indicates that Western banks remain interested in lending to Eastern Europe in the post-Afghanistan atmosphere. Second, the loan signifies a tightening of terms in Euromarket lending—albeit one that is a more general phenomenon and not specific to Eastern Europe. The length of the new loan's repayment term is seven years, shorter than previous loans. And the principal price option, a spread of 3/8% over the London Interbank Offer Rate, is higher than those charged on last year's syndications. With the large improvement in Hungary's current account during 1979, a spokesman for the National Bank has indicated that total borrowing will decline to \$500-\$600 million in 1980.

Hungary's net debt to the West reached \$5½ billion by end-1978, and during the first nine months of 1979 net debt to Western banks rose by another \$708 million. With the sharp rise in indebtedness to Western banks, Hungary has now begun to consider sources of official credit in the West. The country has utilized the U.S. Commodity Credit Corporation for certain agricultural purchases, and has obtained a \$10-million line of credit from the U.S. Export-Import Bank.

A new Politburo in place

In view of Hungary's ambitious economic reforms and the austerity implied for consumers over the next five years, a critical question is whether the new strategy will receive adequate political support. On this front, the prospects appear favorable. The 12th Congress of the Hungarian Socialist Workers' Party, held in mid-March, established a political consensus to implement these policies over the next five years. Several senior party officials were dismissed from their posts, and a new Politburo has emerged. It is probably the youngest and best-trained political leadership in Eastern Europe, and its firm loyalty to First Secretary Janos Kadar promises a united and determined approach to the solution of Hungary's economic problems in the 1980s.

Donald W. Green